

OBBBA Overtime Reporting: What Employers Need to Know for 2026

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As employers begin 2026, public and private employers alike need to prepare themselves for significant tax changes under the federal legislation known as the One Big Beautiful Bill Act (OBBBA). The bill includes legislation impacting income taxes for both tipped employees and overtime pay. Because public sector employers do not commonly employ tipped employees, this article focuses on the “No Tax on Overtime” provisions of the OBBBA.

First, some good news. Although the OBBBA requires employers to report qualified overtime earnings on employee W-2 forms, the IRS notified employers that for Tax Year 2025, employers would not be penalized if they did not report this information. The IRS continues to “encourage” employers to make qualified overtime information available to their employees, but that “encouragement” is not a “requirement.” See IRS Notice 2025-62 (Nov. 5, 2025).

Turning to Tax Year 2026, however, the news is not nearly as good. While employers were granted a reprieve from overtime reporting for tax year 2025, that reprieve is scheduled to end in 2026. Employers unfortunately find themselves at the start of the year having to process payroll without any definitive guidance from the IRS regarding what should be tracked and reported as qualified overtime. Although definitive guidance for employers has not yet been issued, existing guidance to employees offers important insights. See IRS Notice 2025-69 (Nov. 21, 2025). The remainder of this article discusses the overtime tracking requirements that will likely apply in 2026, but it should be remembered that the following information might change based on additional guidance that could be issued by the IRS sometime in 2026.

One of the most significant issues under the OBBBA is that only overtime premiums that are mandated by the Fair Labor Standards Act (FLSA) are considered qualified overtime under the OBBBA. The “straight time” component of overtime pay is not counted towards the tax benefit. Only the half-time premium pay component of overtime is eligible for the tax benefit. Furthermore, payments beyond FLSA requirements—such as double time for working on weekends or holidays—are excluded.

In addition, only overtime required by the statute is likely to be considered “qualified” overtime under the OBBBA. This affects many employers who have overtime pay practices and/or collective bargaining agreements that provide overtime pay in excess of the overtime pay requirements of the FLSA. Similarly, overtime pay obligations imposed by state laws, but not required by the FLSA, are most likely not considered “qualified” overtime under the

OBBBA. In this respect, it is important to note that hours paid but not worked - such as vacation, holidays, sick leave, and other forms of paid time off - do not count as hours worked toward FLSA overtime thresholds. For example, if an employee works 32 hours, takes 8 hours of vacation, then works 8 hours on Saturday, the employee has only worked 40 hours, and is not entitled to any overtime pay under the FLSA. Even if the employer has a CBA that requires the employer to count vacation time as “hours worked” when calculating overtime, the 8 hours of Saturday work likely will not count as “qualified overtime” under the OBBBA.

Unique complications arise for public sector employers that allow their employees to accrue compensatory time. Currently, very little guidance is available from the IRS regarding compensatory time, even in the guidance to employees. The guidance that exists suggests that compensatory time qualifies for the tax benefits of the OBBBA when the time is used, not when it is accrued. For example, if an employee banked 12 hours of compensatory time in 2024, did not use that compensatory time in 2024 or 2025, and then uses their compensatory time to miss work in 2026, the payment of the compensatory time in 2026 is likely to be counted as qualified overtime when it is paid in 2026, not when it was first accrued in 2024, even though the OBBBA was not passed until 2025.

Just like only the 0.5 portion of overtime pay qualifies for special tax treatment, when the employee is paid for their use of compensatory time, only one-third of the payment would be eligible for the tax benefits of the OBBBA. Thus, if an employee is paid \$1,500 in compensatory time, \$500 of that payment qualifies for the tax benefits.

These compensatory time rules create additional accounting nightmares for public employers. Although the IRS has not specifically addressed the issue, it seems likely that since only statutory overtime qualifies for tax benefits under the OBBBA, the same will probably hold true for compensatory time – only compensatory time that was accrued as a result of overtime owed under the FLSA can be considered for the OBBBA tax benefits. Compensatory time accrued as a result of contractual or policy obligations, but not statutory obligations, would not be qualified time under the OBBBA. Accounting separately for FLSA compensatory time in 2026 is a big challenge; accounting separately for FLSA compensatory time accrued in prior years, before the OBBBA was even contemplated, but then paid in 2026, will be even more difficult. Piling on top of those complications, if an employee accrued both statutory and contractual overtime, there is no guidance as to which form of compensatory is used first to know whether it qualifies for the OBBBA tax benefits.

Finally, if you’re not having fun yet, consider the following, additional complication. The OBBBA and related IRS guidance both incorporate the concept of the “regular rate of pay” under the FLSA. In order to qualify for the tax benefits of the OBBBA, overtime pay must be paid based on the employee’s regular rate of pay. Employers frequently under-calculate the

regular rate of pay by excluding “extra” wage payments, such as longevity pay, acting pay, specialty stipends, and on call pay from the calculation of the regular rate of pay when calculating overtime pay under the FLSA. Such under-calculations have always carried a risk of liability under the FLSA in the form of liquidated damages and prevailing-plaintiff’s attorneys fees. Now, not calculating the regular rate of pay correctly carries a further risk that the IRS could get involved with addressing overtime pay that was reported as qualified overtime under the OBBBA, but did not actually meet the definition of qualified overtime because the regular rate of pay was calculated incorrectly.

Stay tuned for updates as the IRS issues further instructions. Work closely with your attorneys and tax advisors to implement tracking mechanisms to be able to report qualified overtime correctly at the end of 2026. If you have not audited your payroll practices to make sure your organization is calculating the regular rate of pay correctly, now is the right time to conduct that audit. Proactive planning now can help avoid compliance headaches later.